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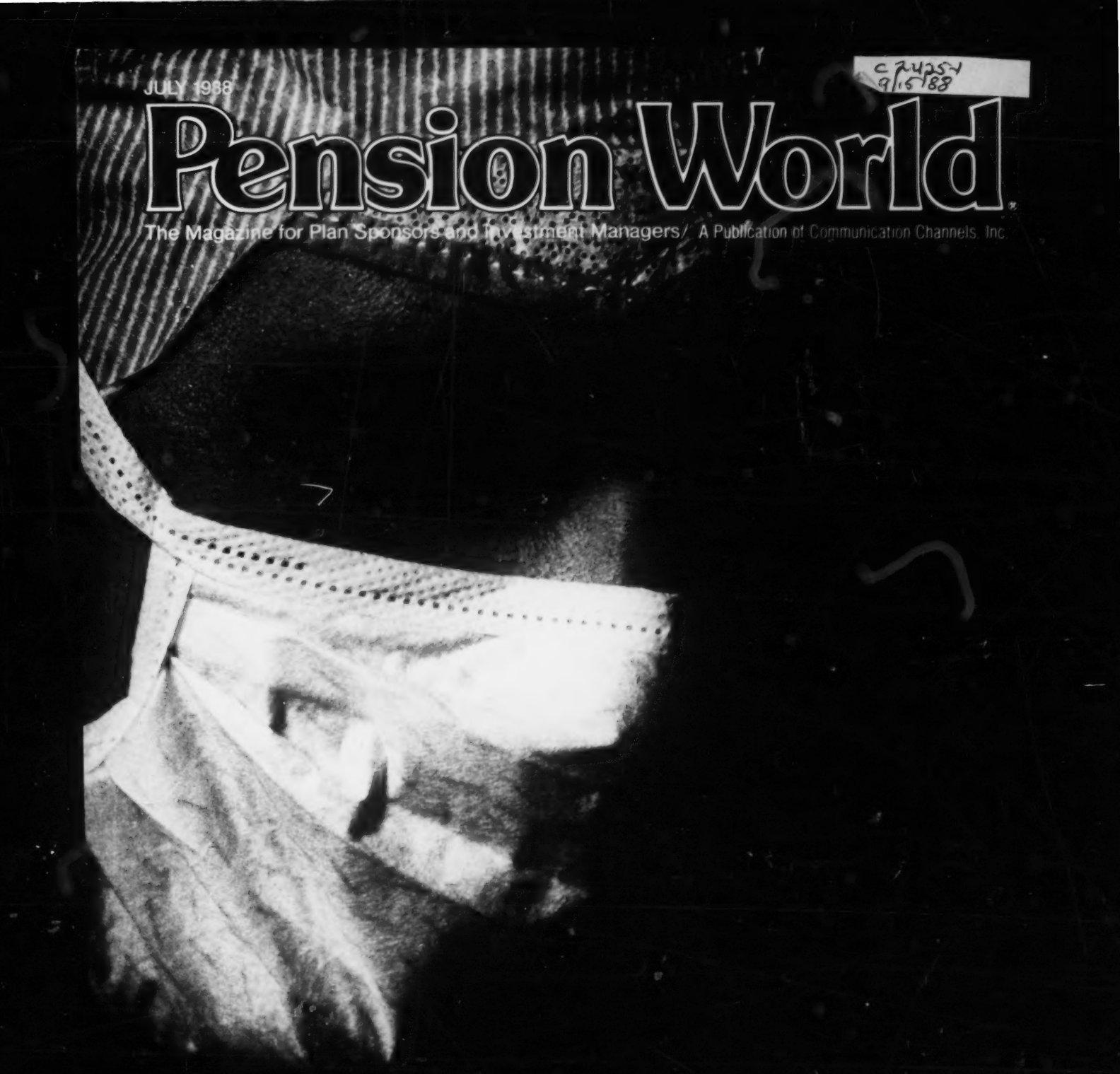

The Future of GICs

The High-yield Portfolio Market Comes of Age

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The high-yield bond market comes of age

Investors now can get more for less with a high-yield portfolio.

by **JAMES L. SULLIVAN**
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Sullivan Money Management
Houston

As the high-yield market continues to mature in terms of size, number of participants, and user understanding and ability, high-yield bonds will increasingly fulfill a number of varied portfolio goals that were previously unattainable with fixed-income investments.

For instance, a well-managed, high-yield bond portfolio can mimic in risk and performance each of the following types of "normal" portfolios. These portfolios include a growth-stock portfolio of either small capitalizations or traditional growth stocks; a balanced portfolio with percentage adjustments between both income and equity exposures based on market expectations; and a normal fixed-income portfolio.

Moreover, the high-yield portfolio has the added advantage of generating a higher income than each of the above, without adding perceived or defined risk. It is possible for the astute investor to enjoy the higher returns and avoid significant financial losses—despite the publicized magnitudes of the Texaco and LTV defaults and justified worries that default rates will accelerate dramatically in a recession.

Analyze all bonds

In today's financial environment, all markets are exposed to credit loss from principal-deterioration. This risk cannot be wholly attributed to the high-yield market. Whether investment-grade or high-yield, fixed-income investments must be carefully analyzed. In addition to their own credit research, investors may now utilize the zeta scores developed by Dr. Edward Altman, professor of finance at New York University and a consultant to Merrill Lynch's high-yield debt group, and MAD ratios developed by Drexel Burnham Lambert. Both measures can be applied to investment-grade securities.

It is the perceived default risk of "junk bonds" that has gained notoriety among pension-fund managers for these fixed-income investments. As shown in table A, when measuring rates of return against the actual gross default rate, the average 300 basis-point yield over "normal" bonds more than compensates for this controllable risk.

The new methodologies enable fund managers to manage risks more efficiently than at any time in financial history. Table B shows the historical default rates since 1970. While default rates have actually remained fairly steady over the long-term, the techniques developed by Dr. Altman and others mean the risk of financial loss in the high-yield market can be efficiently managed and somewhat reduced. The magnitude of default risk in credits can be monitored, and investors alerted, through the use of zeta scores.

However risk is measured, the magnitude of actual defaults is manageable when net recoveries are taken into account. Dr. Altman found that the actual rate of net loss from default during the years 1974 to 1986 was equal to 1.095 percent.

As the default risk of high-yield investments has become subject to control, the market risk of illiquidity has also diminished. The listed markets for stocks and government-bond markets have much greater liquidity than the high-yield market. However, the liquidity gap has narrowed greatly over the past three years and will continue to shrink as more money is committed to high-yield investments.

Liquidity is rapidly improving as the securities industry devotes more capital and staff to the market. National securities brokers with worldwide distribution capability, such as Merrill Lynch and Shearson Lehman Hutton, have steadily increased the number of their high-yield underwritings since 1982. Merrill Lynch, for instance, completed 25 deals in 1986 that raised $3.7 billion, compared to seven deals in 1982 that garnered $699 million. Even such traditional investment-banking firms as Morgan Stanley and First Boston are major participants in the market.

For high-yield investors, it is often harder to predict the timing of market performance. Since the market for high-yield investments still is new and encumbered by normal (and some abnormal) growing pains, the predictable results for each investment are often in question.

Risk is controllable and is more than compensated for by the returns in the high-yield market. During the years 1976 to 1986, for instance, Lipper Analytical Services found that 37 corporate A-rated bonds yielded 163 percent compared to 40 high-yield bonds that earned 175 percent during the same period. By way of comparison, 45 U.S. government bonds yielded 156 percent.

The benefits of high-yield investments, however, are not limited solely to the economic effects of higher yields. Such return differentials translate into significant dollar amounts, and this extra income will allow the pension/endowment administrator to redirect the total funds distribution. The added funds can be diverted to appropriate areas as determined by the market outlook and other pressures of the investment universe, permitting an investor to adjust the portfolio mix without having to sell asset positions.

One of the ongoing debates among account administrators concerns the proper distribution of their investments and the ability to monitor and adjust distribution of investment assets as market, economic or internal business requirements demand changes. The flexibility represented by high-yield cash flows enables the administrator to efficiently and economically make such portfolio adjustments.

While adding flexibility to the portfolio mix, these added funds also represent "surplus" cash in the investment account. The buildup of a surplus is particularly beneficial in view of the volatility of all markets and the threat of "silver bullets"—random events that can devastate an investment account, but that cannot be repelled, except by a buildup of cash. Silver bullets would include the early retirement of current employees due to business conditions, labor contracts that change benefits of retired employees, etc.

Comparing methodologies

With high-yield risks and rewards analyzed, a comparison can be made of portfolio methodology. First, the growth-stock portfolio with either small capitalization or traditional growth stock could be delineated by the following characteristics:

1. The stocks would have a low yield (if any). The stocks were not purchased for income purposes. With the current tax laws, there is no tax benefit to generating capital gains like there has been in the past.

2. In consort with Item (1), the portfolio emphasis is on market gain in individual holdings. Performance will be dependent on stock selection and subsequent positive market responses. The new tax may negate some appeal of this exclusive approach.

3. Attention is paid to the volatility of the portfolio and the individual stocks, because the emphasis for portfolio performance is based on Item (2). The higher the portfolio's volatility, the greater the assumed risk.

4. The analysis of growth stocks normally leads to securities with high price/earnings ratios. The P/E ratios would average 1½ times to 2½ times normal Dow Jones P/E ratios. The higher the P/E ratio, the greater the average risk of poor performance by the stock on any company disappointments.

Risk is, therefore, inherent in any growth-stock portfolio, because its orientation to performance is change in stock markets, and there is little cash flow generated from the portfolio that might act as a market-loss buffer.

TABLE A

HIGH YIELD SPREAD VS. TREASURIES:

1980	359 Basis Points
1981	362 Basis Points
1982	504 Basis Points
1983	332 Basis Points
1984	321 Basis Points
1985	362 Basis Points
1986	493 Basis Points
Average	390
Default Loss	97 Basis Points
Net Average	293

TABLE B

HISTORICAL DEFAULT RATES-LOW RATED, STRAIGHT DEBT ONLY

($ Million)

Year	Par Value Outstanding with Utilities	Par Value Defaulted	Default Rate
1986	$92,985	$3,155.76	3.394%
1985	59,078	992.10	1.679
1984	41,700	344.16	0.825
1983	28,233	301.08	1.066
1982	18,536	577.34	3.115
1981	17,362	27.00	0.155
1980	15,126	224.11	1.482
1979	10,675	20.00	0.187
1978	9,401	118.90	1.265
1977	8,479	380.57	4.488
1976	8,015	29.51	0.368
1975	7,720	204.10	2.644
1974	11,101	122.82	1.106
1973	8,082	49.07	0.607
1972	7,106	193.25	2.719
1971	6,643	82.00	1.234
1970	6,996	796.71	11.388
	Average Default Rate-1970 to 1986:		2.216%
	Average Default Rate-1974 to 1986:		1.671%
	Average Default Rate-1978 to 1986:		1.451%
	Average Default Rate-1983 to 1986:		1.727%

Source: Morgan Stanley

The normal fixed-income portfolio, on the other hand, would be delineated by the following characteristics:

1. All the securities would normally have a stated income stream attached.

2. It usually is looked on as a defensive portfolio, but with the new market volatility of the past five years, defensive may be a misnomer. In fact, market statistics in the past 18 months imply a greater volatility in the government-bond market than in the high-yield market. The U.S. government market is the world's political play pen—to enforce or sway political desires and interest-rate levels.

3. The actions of the U.S. government and its agencies, as well as foreign governments and their respective agencies, can greatly affect the performance of the government-bond market.

4. The securities can now be selected from a wide variety of instruments, and new variations are being developed constantly. In fact, fixed-income has become a misnomer since many securities now have adjustable income streams. In addition, many are retired in principal based on movement in interest rates, such as in the case of asset-backed securities.

Although income still can be generated, all fixed-income portfolios must expect high market volatility and potential credit deterioration based on economic change.

The third, and most common, portfolio is a combination of equity and fixed-income instruments distributed within the portfolio and based on market expectations. The portfolio would be delineated based on the following characteristics:

1. It will have funds invested in both stocks and fixed-income prepositions on a percentage basis, reflecting market outlook.

2. Some income is generated from fixed-income investments.

3. Market gains are generated from equity investments.

4. Market changes affect the performance of both portfolio group areas.

5. Consequently, the portfolio has both offensive and defensive characteristics derived respectively from the equity and fixed-income areas.

This portfolio's performance may be below market value because of the action of these areas and the increased volatility of each market.

The fixed-income portion of a balanced, high-yield portfolio should be constructed of credits with a low probability of movement in either direction.

It is important to note that out of the 25,000 companies whose assets exceed $35 million, only 5 percent would receive an investment-grade rating if they were to request it. In addition, out of the approximately 1,400 companies currently rated, only 50 percent are investment-grade. Therefore, the universe of candidates for investment purposes in the high-yield area is quite large.

A portfolio manager could therefore change the risk level and become more defensive or offensive by changing the mix between the credits in the two sectors and the amount of funds committed to the growth or credit portion of the fund. In addition, the manager could emphasize only offense or only defense in order to mimic either the growth-stock portfolio or the fixed-income portfolio.

The major attribute of this balanced high-yield fund is the tremendous increase in cash flow that is generated. The added cash flow provides the investor with a great deal of flexibility and an acceptable level of safety. If in today's market the average yield on a balanced portfolio is 6 percent, with a distribution of 60 percent equity and 40 percent fixed-income and cash equivalents, and the yield on a balanced portfolio of high yield distributed on the same 60/40 basis is 11 percent, the differential of 500 basis points will mean a doubling of principal in about 13 years. This cash-flow power adds tremendous liquidity and safety to the entire portfolio.

In short, the investing public, especially pension funds and endowment funds, can achieve their investment goals by utilizing high-yield credits while receiving superior cash flows. Risk exposure is controllable, and higher returns can be attained. □

James L. Sullivan is president of Sullivan Money Management Inc. in Houston. He has been a money manager for nearly two decades. Mr. Sullivan received a Bachelor's degree in business administration and an MBA from the University of Texas.

Cases & Rulings

Continued from page 48

(2) qualified employee discount,
(3) working condition fringe, or
(4) de minimis fringe

* * *

(e) DE MINIMIS FRINGE DEFINED. — For purposes of this section —

(1) IN GENERAL — The term "de minimis fringe" means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.

10. Code § 132(e). *See also* Temporary Reg. § 1.132-6T.

11. Section 3401(a) provides:

for purposes of this chapter, the term "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash; except that such term shall not include [various exceptions not applicable to our situation].

12. Temporary Reg. Section 31.3401(a)-1T provides:

Q-1: Are fringe benefits included in the definition of "wages" under section 340(a)?

A-1: Yes, unless specifically excluded from the definition of "wages" pursuant to section 3401(a) (1) through (20). For example, a fringe benefit provided to or on behalf of "wages" if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117 or 132 [of the Code].

13. *Id.* at § 31.3501(a)-1T, Q&A 5,6.

14. *Id.* at Q&A 10.

15. *Id.* at Q&A 1.

16. IRS Circular E, Employer's Tax Guide.

17. In addition to federal income tax withholding, an employer also is obligated to withhold for state and local income taxes, social security, unemployment and other taxes. Although it is beyond the scope of this article to discuss these other withholding obligations, we note that the issues discussed herein with respect to federal tax withholding are applicable to these other taxes as well.

18. A potential complication with delaying withholding, however, is the possibility that an employee may terminate his or her employment after the fringe benefit was received, but before the employer withheld amounts for federal income (and other) taxes. In that event, it is possible that the employer may be liable for the tax payment on such amounts.